Technical analysis pulled out of the bin

By Jonathan Davis

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Three years ago in this space I noted that Dow Theory had given an important technical signal on November 23 2007 indicating that the US equity market had entered “a primary down trend”. Although the equity market looked temporarily oversold, what it appeared to mean, if you believed in such things, I suggested, was that “investors should be preparing for a market whose underlying trend from here is down, not up”.

Well, that didn’t turn out to be a bad call, as the Dow Jones index subsequently fell by 50 per cent to its March 2009 low, and as of last week was still trading 15 per cent below its level at the time the signal was given. If making market predictions was my only business, as opposed to a sideline, I would by now be trumpeting my amazing track record to anyone who cared to listen.

As it happens, while the technical signals were one of the things that made me cautious on the equity markets in late 2007, in truth my bearish stance was driven more by experience and the negative things I was hearing from professional contacts (including central bankers who admitted privately to having no confidence that they could stop the escalating banking crisis).

Honesty also requires admitting that most of my 800 words were not about the coming market crash, but a discussion of whether **technical analysis** had any value. My conclusion was that it did best when interpreted by experienced market practitioners with good judgment. “Its real value” I suggested “lies in the quality of the interpretation, and that is ultimately subjective, rather than scientific”.

Well, I wouldn’t change a word of that conclusion, but it is fair to say that technical analysis is undergoing a revival from the days when it was routinely dismissed in the academic literature as little more than charlatanism. In his seminal book *A Random Walk Down Wall Street*, published in 1973, Professor Burton Malkiel dismissed technical analysis with a withering conclusion: “under scientific scrutiny, chart-reading must share a pedestal with alchemy”.

Of course, we now know that the random walk, and the efficient market hypothesis to which it is related, were just beginning to dominate the way that academics thought about financial markets. Neither theory seemed to leave any room for technical analysis, which self-evidently was based on the assumption that there was information in security prices that could be exploited by investors either for profit or the avoidance of loss.

The fact that so many investors have continued ever since to rely on price charts to assist decision-making suggests the market itself refuses to accept that technical analysis can be so easily refuted. Technical analysis remains the dominant form of analysis in commodity and foreign exchange trading. Sushil Wadhwani, an academic who later moved into investment management, says overcoming the prejudice against technical analysis was the most important lesson he had to learn when moving from the ivory tower into the laboratory of real life experience as a trader.

As a new book by Andrew Lo and Jasmina Hasanhodzic makes clear, the past 20 years have seen the start of a serious re-evaluation, to the point where it is no longer credible to sweep it away as worthless. Prof Lo, one of the brightest stars in the MIT finance faculty, has done as much as anyone to demolish the credibility of the efficient markets hypothesis, and while far from starry-eyed about what technical analysis can rightly now claim to be, concludes that it is "a legitimate and useful discipline, tarred by spurious associations and deserving of further academic study".

A number of recent academic studies have been able to test various trading strategies and found scope for potential profit in them. Other studies have used complex programming to work out from actual market movements trading strategies that would have worked well; often it turns out they correspond closely to seemingly simplistic charting formulae involving moving averages.

The most intriguing finding, though, to my mind, is the evidence the authors present, based on research by Professor Emanuele Viola of Northeastern University, that the human eye is capable of detecting sophisticated and meaningful patterns in price charts which even the most sophisticated computer programmes cannot do. They show human beings can consistently distinguish between graphs of actual financial market returns and those generated at random. This opens up the intriguing possibility of harnessing the human skills of pattern recognition to computer-generated algorithms, which are designed to counter the inconsistency and emotional biases to which human investors are also prone.

Even though the investing world has been transformed over the last generation, one has to conclude the exceptional power of the human brain to find meaning in complex patterns lives on. Investors who go on reading price charts, in any event, no longer need to apologise for their strange pastime.

Andrew W. Lo, Jasmina Hasanhodzic, *The Evolution of Technical Analysis: Financial Prediction from Babylonian Tablets to Bloomberg Terminals* is published by John Wiley. You can buy a copy through the Independent Investor bookshop by following this **link.**

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